

What's Next??

By Rick Swig, ISHC

The hotel real estate sector has been anything but boring for the last few years. Driven by the escalating financial boost of the public markets in 1986, the sector has been the scene of shark-like feeding frenzies and chaotic consolidation as public companies moved to grow portfolios and boost stock prices.

Wall Street investors responded by committing capital to the hotel sector as initial public offerings were followed by other secondary offerings. Portfolios and stock prices grew (along with investor smiles) until the balloon burst last August and suddenly the seeming endless flow of capital was reduced to a dribble, along with portfolio growth and, of course, transactions.

There was some adjustment in structures, as REITs clipped on C-corps and reinvented their businesses. Post-August repricing presented new investors in REIT stocks some double-digit annual yields based on continuing dividend structures. This, however, still did not and has not budged stock prices upwards, as the potential for continued revenue growth based on operations and acquisition has not been proven.

This article is written near the end of the first quarter and well before its publication. Therefore its view may be dated. At this juncture, however, both new development and the transaction market do not seem to be gathering any significant momentum. This is a result of unwilling buyers and sellers, lack of financing, and product availability.

Product has found itself onto the market, as some REITs have begun a shedding process where non-essential assets are not being strategically removed to either raise capital or optimize portfolio performance. Most REIT growth will not emerge through acquisition or development, but through operating profits.

First quarter operating growth trends are not entirely inspiring, but operating profit yields are not significantly deteriorating either. Some REITs were viewed to have paid too aggressively for some underperforming hotels. Now, these companies may have the last laugh as those same assets are leading the growth potential curve, while other more historically high performing assets are hitting occupancy, room rate, or profit plateaus.

Most Smith Travel Research 1998 year end market comparisons indicated that the past year yielded some streaking room rate growth, but possibly some solid ceilings on occupancies. Although there has been some slowing, the general revenue trends for

the remainder of the year and into 2000 are still fairly positive.

Additionally, hotel customers have so far been tremendously cooperative. Customers have responded to the urgings of promotions touting "weekend vacations" to develop a solid market segment. Frequent guest programs have created loyalty in the commercial traveler segment and transferred that loyalty into the leisure segments based on program prize benefits. Business travelers have become price tolerant, as the importance of getting a hotel room in many markets has become more important than the rate on the room. Finally, the healthy economy has stimulated record breaking attendance at trade shows and conferences. All of this being said, however, there must be a peak in every cycle.

This stimulates some serious questions as to the potential of REVPAR growth. Ultimately the room rate growth cycle must slow and occupancy stabilization might be the best expectation. This would come as a result of softening domestic economic trends or the inevitability of new supply with certain demand dilution.

Given that situational analysis, hotel real estate investors continue to be circumspect about the market. The availability of high yield assets seems to be long gone. The accessibility of work out properties with relatively short-term disposition potential also seems limited.

For sellers the above scenario along with the lack of REIT capital has removed the demand and therefore acquisition pressure from the marketplace. Where return on investment hurdles based on potential asset disposition momentum seemed relatively easy to achieve a year ago, now these sales thresholds often seem to be on distant horizons.

Due to the peaking of REVPAR in individual geographic markets coupled with continued inflexibility in asset pricing, new investment in hotel assets may have to be completed with a long-term vision rather than with a quarterly earnings perspective. As a revenue "slowdown", a word not to be interpreted as "crash", is inevitable, ten-year outlooks may replace short-term yield orientations. This trend might close the door for REIT investment which would require predictable ongoing cash yields for dividends.

Growth through acquisition opportunities probably return to the hotel operating companies, which would find benefit in not only solidly performing assets, but assets which will also enhance strategic geographic positioning or assure ongoing management fees. Joint venture opportunities might lie with private capital sources, which are less sensitive to the need for consistent revenue growth during regular operating periods.

Entrepreneurial vision, as much as or more than analytical projection, may play a major role, if the transaction impasse is to be overcome. Then again, the transaction doldrums may continue, as real estate investors find more opportune pastures in other real estate sectors.

"Disciplined hotel real estate investor (developer)" may be considered an oxymoron. The cynical view therefore would have the lack of transaction liveliness and resulting boredom stimulating investment activity for personal productivity rather than all together financially constructive reasons. Any inclinations in this direction would perpetuate the aforementioned "slowdown" trend into the momentum of "crash."

There are still hotels that are worthwhile acquisitions, even at possibly inflated prices. There are certainly selective markets where new development in multiple hotel product segment are justified and needed. As some geographic areas have slowed, others are only just beginning to build either as commercial or leisure destinations. Although REIT investment pressure may have faded for the time being, other investor segments which are not governed by Wall Street earnings parameters will find good (and a few not so good) opportunities.